Securities Industry

Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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COPING WITH COSTS IN A REVENUE DROUGHT

On the eve of the anniversary of last year's stock market crash, one fact has become perfectly clear: until revenue sources rebound, securities firms must continue to limit their costs or face ever narrowing bottom lines.

Highlights

1. The securities industry managed to bring average quarterly expenses down 4% in 1988's first half vs. 1987's quarterly average. Since revenues held even, average profits doubled over last year's admittedly anemic level.

2. While costs and profits improved for the half vs. 1987's rock bottom levels, 88's profit margin and ROE virtually tied 1984's performance, the second lowest of the Eighties.

3. Despite strenuous efforts at cost control, the industry's profitability in the second quarter fell 50% from the first quarter whether measured by total profits, profit margins, or ROE.

4. Retail-oriented firms are still the hardest hit. Average revenue per employee at the Regional firms is down $19,000 per person for 1988 vs. 1987 and down a shocking $64,000 per person at the Discounters.

5. Reflecting a capital base which has been expanding much faster than the revenue it generates, the securities industry now books only $2 in revenues for every $1 in equity capital. In other words, the industry, today, because of a much greater capital base, would have to more than double its 1980 profit margin (its highest since 1972) in order to just match its 1980 ROE!

INTRODUCTION

We are fast approaching one year since the October 19th meltdown and conditions continue to deteriorate in the securities industry. In our previous profitability analysis, we noted that the aftershocks of October 19 were still being felt by the securities industry and capital markets. One of our key findings was that the aftershocks have been mainly felt in the retail area. The most recent data, which includes the second quarter of 1988, shows that firms concentrating in the retail sector are facing further profitability deterioration while even the investment banking and trading hemisphere saw profit margins and returns on equity deteriorate in the second quarter.

Financially, conditions deteriorated for the industry during the second quarter as revenues dropped about $600 million while costs remained flat at $11.9 billion. Revenues declined from $13.0 billion to $12.4 billion during the 2Q88. Commission revenues were down by roughly $200 million, trading profits by over $400 million while firm investment accounts dropped another $600 million. These declines were offset partly by increases in underwriting revenues of $200 million and revenues related to the securities business, up $300 million, mainly reflecting increased M&A activity.

Any modest gains that were achieved in cost savings between the 1Q88 and 2Q88 were wiped out by a $200 million increase in interest expense due to rising interest rates. Thus, with costs literally flat between quarters and revenues falling about $600 million, the entire revenue decline was felt in profits which plummeted from $1.1 billion to about $550 million. The industry's pre-tax profit margin and ROE were literally cut in half between the first and second quarters of 1988. Pre-tax profit margin and ROE fell from 8.7% to 4.8% and from 18.1% to 9.3%, respectively.

Pre-tax profit margin and ROE were 6.7% and 13.4%, respectively, for the 1H88. Although these figures are disappointing, particularly given the risk and volatility of earnings in the securities industry, the 1H88 figures are higher than those for the worst years in the 80's, 1984 and 1987. In those two years, pre-tax profit margins were 5.2% and 2.3% respectively; while pre-tax ROE was 13.3% and 4.9% respectively. These comparisons are shown in Table 1.

Table 1

POOREST PROFIT PERIODS OF THE EIGHTIES

	1984	1987	1H88
Pre-tax Profit Margin	5.2%	2.3%	6.7%
Pre-tax ROE	13.3%	4.9%	13.4%

Despite strenuous efforts at cost control, the industry's profitability in 2Q88 still fell more than 50% whether measured by total profits, profit margins, or return on equity. For the first six months of this year, ten of the fourteen cost lines on the FOCUS Report

showed declines relative to 1987 on an average quarterly basis. Nevertheless, average quarterly costs were only reduced by slightly over 4% in the 1H88 relative to 1987.1/

Surprisingly, "clerical and administrative" costs, on an average quarterly basis, were up almost 6% in 1988. This cost increase occurred despite a decline of about 6% in non-producing employees since the crash and a 1.3% drop in the average number of non-producers during the 1H88 relative to the average number of such employees in 1987. Based on the FOCUS Reports, "non-producers" declined by 6,784 as of June 30, 1988 relative to the average figure in 1987, 162,806, and declined a greater 12,215 from their peak level 12 months earlier. This category is a very broad classification of employees including everybody but producing RRs. But, it suggests that unless conditions improve soon in the industry, further layoffs may take place, raises may be curtailed, or the possibility of cutbacks in wages and salaries being imposed upon the current labor force. Though much has been already imposed along these lines (see next section on employment and compensation), some firms, particularly the retail-oriented, have room for further tightening.

The other major cost item limiting the overall cost decrease is interest expense which was down only 2.5% during the 1H88 relative to the quarterly average in 1987. For the most part, this was due to interest rates trending upwards since 1987. The six-month commercial paper rate rose from 6.8% in 1987 to 7.5% in June 1988 while most other short and long term rates were also up from 50 to 100 basis points over 1987's average. Since clerical and administrative salaries plus interest expense comprise almost 50% of the industry's total costs, it is clear why overall costs are down only 4% with interest rates rising and clerical and administrative salaries actually higher than in 1987.

In order for further improvements to be made on the cost front, interest costs have to be curbed further. This will be difficult to achieve given the surge in rates in August. During the 1H88, the yield curve has been narrowing. From January-June, rates on federal funds and 3-month T-Bills went up about 70 basis points. Meanwhile, rates on 10, 20 and 30-year Treasuries went up 26, 16, and 17 basis points, respectively.

A further tightening of clerical and administrative salaries seems to be the only cost item with room for further improvement in 3Q88. This improvement may come not from eliminating additional job positions, but limiting increases in salaries that have gone to certain employees remaining on the payroll, or outright further reductions (see next section). For clerical employment, this cost item has been exceeding the average for 1987, despite a reduction in the number of such employees. This trend cannot continue unless the environment surrounding the industry suddenly improves or, more specialized employees with greater training and experience are being retained while less "essential" employees are being let go. Frankly, there is no evidence about this possibility, one way or another.

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1 According to the latest FOCUS Report, about 3,400 jobs were eliminated by NYSE firms dealing with the public during the second quarter of 1988. This was about 1.4% of the labor force as of March 30, 1988. Interestingly, according to figures released by the Toronto Stock Exchange, almost 600 jobs were eliminated by members during this same time period. These jobs represented about 2.4% of the Canadian securities industry's labor force, leaving them with 24,274 employees as of June 30. See Financial Times, September 22, 1988, p. 22.

Since employment and compensation are so large a cost factor for the securities industry, let's review what has already occurred on this front since last year.

EMPLOYMENT AND COMPENSATION

As discussed earlier, securities firms have moved rapidly to contain and curtail expenses since October's events plunged the markets into rough waters. Since the securities industry expends over 40¢ of every $1 of revenue on direct compensation alone, headcount was the first and prime target of cost control measures. Table 2 shows the immediate result of these measures. Over the nine month period beginning September 30, 1987, just 19 days before the "crash," until this past June 30, over 17,000 jobs, or 6.6% of the workforce, was eliminated or left the securities industry. The bulk of this loss was at the National Full Line firms, both because they employ the vast majority of securities industry personnel (see Appendix A) and because of the elimination of positions from the combination of the two mega firms, Shearson Lehman and E.F. Hutton.

Table 2

NET EMPLOYMENT CUTS SINCE THE CRASH*

Category	Producers		Non-Producers		Total	
National Full Line	(7,012)	(11.4%)	(4,481)	(5.1%)	(11,493)	(7.7%)
Large Investment Banks	(449)	(4.6%)	(2,668)	(9.7%)	(3,117)	(8.4%)
Regional Firms	(105)	(0.6%)	(1,367)	(5.6%)	(1,472)	(3.5%)
NYC-Based Regionals	(184)	(3.3%)	(111)	(1.1%)	-(295)	(1.9%)
NYSE Discounters	68	6.5%	(245)	(6.6%)	(177)	(3.7%)
All Other	43	3.1%	(689)	(6.0%)	(646)	(5.0%)
Total Industry	**(7,639)**	**(7.9%)**	**(9,561)**	**(5.8%)**	**(17,200)**	**(6.6%)**

*Employment change 9/30/87 to 6/30/88.

Nevertheless, over 8% of the Large Investment Bank workforce has been trimmed and except for a 2% net reduction in the New York City-based regional workforce, other categories of firms witnessed 4%-5% net reductions.

But these are just comparisons of staffing levels at two points in time. A better comparison, from a cost comparison perspective, is to look at last year's average employment levels vs. this year, and comparative compensation levels.

The mean employment of the industry so far in 1988 is 251,271 employees (average of beginning employment and levels at the end of each of the two quarters through June) as seen in Table 4. This is down only 1.7% from the mean employment last year (average of the 1987 beginning employment level and levels at the end of each of the four quarters), although the June 30 level is a lower 244,963. Also, though all categories of firms have had net employment reductions from their pre-crash highs, this year's average employment is down only slightly from last year and for some groups, such as the NYCs and Discounters, average employment is actually up! The net reductions, so far, have served to eliminate the added employment prior to the October 19 crash.

Table 3

TOTAL COMPENSATION EXPENSE

(In $ Millions)

	1987	1988*	$ Change	% Change
National Full Line	10,568.0	10,004.4	(563.6)	(5.3)
Large Investment Banks	4,209.0	4,271.6	62.6	1.5
Regionals	2,773.5	2,312.8	(460.7)	(16.6)
New York City-Based	1,632.5	1,457.6	(174.9)	(10.7)
Discounters	307.9	294.4	(13.5)	(4.4)
Total Industry	**20,553.5**	**19,410.2**	**(1,143.3)**	**(5.6)**

*First Half Annualized

Table 4

AVERAGE EMPLOYMENT

	1987	1988*	Change	% Change
National Full Line	146,989	141,953	(5,036)	(3.4)
Large Investment Banks	36,201	35,479	(722)	(2.0)
Regionals	41,124	41,022	(102)	(0.2)
New York City-Based	14,812	15,891	1,079	7.3
Discounters	4,488	4,764	276	6.1
Total Industry	**255,655**	**251,271**	**(4,384)**	**(1.7)**

*First Half

However, although average employment has fallen less than 2% since last year, total compensation costs have been cut almost 6% (Table 3). The industry spent $20.6 billion on direct compensation in 1987, but annualized first half compensation is $19.4 billion, more than a $1 billion savings and more so if the trend continues down for the remainder of the year, which appears extremely likely as of this writing.

For some categories of firms, the compensation cuts are more impressive. Regional firms' 1988 average employment is only 0.2% (or about one person per firm) below last year's average. Meanwhile, their annualized 1988 compensation expense is running almost 17% below last year's! Also, NYCs and Discounters, though mean employment has risen slightly, have managed to cut this year's compensation costs.

Again, these are statistical averages and are not intended to portray, for instance, that the typical Regional firm has not seen employment reductions, but compares net average employment and compensation expense of the entire group for 1987's full year to 1988's first half. If one looked at just six month reductions through June, Regionals' employment fell over 2,000, or over 21 employees per firm, but this does not relate to average employment and compensation.

Have these cost control measures increased productivity of the remaining workforce and reduced expenses? Comparing the average compensation per employee last year to the revenues generated per employee last year relative to 1988 (first half annualized) shows some striking examples. For the securities industry as a whole, 1988's compensation expense was slashed 5.6%, but per employee it was not as drastic -- a 4% drop, since average employment was cut 1.7%. Meanwhile, the remaining, albeit smaller, workforce managed to generate 2.2% more revenues per person than last year. That's good, but hardly a quantum leap in productivity. Further, that increase in revenue per employee is concentrated in the investment banking-oriented firms, LIBs and NYCs, which have seen their revenues and profits boosted by the only businesses still strong this year, such as M&A fees. Reflecting the plunge in equity and mutual fund business,[2] Regionals' revenues per employee are down 16% while Discounters' are down 24%!

These "productivity" trends show once again that securities firms often cannot control their own destiny and are extremely dependent on external factors affecting the psychological and economic environment in which they operate.

Table 5

AVERAGE REVENUE PER EMPLOYEE

(In $ Thousands)

	1987	1988*	$ Change	% Change
National Full Line	147.5	145.5	(2.0)	(1.4)
Large Investment Banks	408.1	445.8	37.7	9.2
Regionals	120.6	101.7	(18.9)	(15.7)
New York City-Based	306.3	314.7	8.4	2.7
Discounters	274.2	209.9	(64.3)	(23.5)
Total Industry	**198.7**	**203.1**	**4.4**	**2.2**

*First Half Annualized

Meanwhile, the compensation drops are merely matching, or worse, falling short of the revenue declines. Regionals' average compensation per employee fell $11,000, far short of their $19,000 drop in revenues per employee, while Discounters' severe $64,000 drop in revenues per employee far exceeds their $7,000 drop in compensation cost per employee this year!

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[2] The net sales of equity, bond and income mutual funds continue to remain vastly depressed relative to immediate prior years. Through the first half of 1988, only $3.6 billion of net sales were made. This compares with over $74 billion of net sales in 1987 and over $148 billion in 1986, and about $81 billion in 1985. We have to go all the way back to 1982 before the net sales for the first half even approach an annual level for an earlier year.

Table 6

AVERAGE COMPENSATION PER EMPLOYEE

(In $ Thousands)

	1987	1988*	$ Change	% Change
National Full Line	71.9	70.5	(1.4)	(1.9)
Large Investment Banks	116.3	120.4	4.2	3.5
Regionals	67.4	56.4	(11.0)	(16.3)
New York City-Based	110.2	91.7	(18.5)	(16.8)
Discounters	68.6	61.8	(6.8)	(9.9)
Total Industry	**80.4**	**77.2**	**(3.2)**	**(4.0)**

*First Half Annualized

Table 7

AVERAGE NET REVENUE PER EMPLOYEE

(In $ Thousands)

	1987	1988*	$ Change	% Change
National Full Line	75.6	75.3	(0.3)	(0.4)
Large Investment Banks	291.8	325.4	33.6	11.5
Regionals	53.2	45.3	(7.9)	(14.8)
New York City-Based	196.1	223.0	26.9	13.7
Discounters	205.6	148.1	(57.5)	(28.0)
Total Industry	**118.3**	**125.9**	**7.6**	**6.4**

*First Half Annualized

Therefore, the retail-oriented firms' after-compensation net revenues per employee fell from 1987 to 1988. Despite employment cutbacks and a reduction in compensation for the remaining workforce, the slowdown in retail business has been so severe that the net revenue per employee couldn't be maintained. For the NFLs, the net revenue drop was only $300 per employee, or 0.4%, but the NFLs have just as large an investment banking source of revenues as the LIBs, the one area still humming along so far in 1988.

Regionals, which also have investment banking revenues, albeit much smaller, saw their net revenue per employee fall 15%. Discounters, almost entirely retail commission dependent, saw their net revenue plummet $57,500 per employee or 28%!

The investment banking concentrated firms, LIBs and NYCs, saw these figures rise $34,000 and $27,000 per head, respectively, or 12% and 14%. These two groups helped bring up the net revenue per employee figure for the total industry, with a $7,600 or 6.4% rise for 1988 over 1987.

So, where most of the aggregate employment reductions have occurred, at the NFLs, on a firm-wide basis these reductions, coupled with lower compensation, have kept the net revenue per head constant during these tough times. And though there's a vast difference between the purely retail and purely investment banking firms, as an industry, the remaining workforce is managing to generate roughly the same amount of revenues and net revenues per person in 1987 and 1988.

Furthermore, this year's showing is still impressive compared to the bull years of the Eighties. Table 8 shows that the total revenues generated per employee has been growing across the board, and 1988's results, given the poor market environment, are historically quite good. Of course, each employee has more of other resources to work with in terms of both capital and technology which are essential to their productivity.

Table 8

REVENUE PER EMPLOYEE

(In $ Thousands)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	90.5	89.6	98.6	114.8	106.6	131.1	157.6	147.5	145.5
Large Investment Bks	232.9	316.5	348.6	342.8	402.1	448.8	490.9	408.1	445.8
Regionals	N.A	87.1	89.1	105.9	89.5	112.6	130.7	120.6	101.7
New York City Based	N.A	136.4	131.9	156.7	145.5	167.7	290.9	306.3	314.7
NYSE Discounters	N.A	189.1	176.2	213.8	171.3	180.7	261.0	274.2	209.9
Total Industry	**114.6**	**123.2**	**135.8**	**154.0**	**150.5**	**180.0**	**213.7**	**198.7**	**203.1**

*First Half Annualized

However, though revenue per employee appears to have improved over the years and is holding its own in these rough times, returns earned on non-labor resources -- read capital -- have been deteriorating, as the next section shows, long before this year's bear.

PROFITABILITY AND THE CAPITAL MYTH

The most frequent or popular cycles used in measuring the securities industry's profitability are the "comparable year-ago period" or a bull vs. bear market period. For the latter, October 19, 1987, is now the scale's fulcrum when weighing industry profits and losses.

That's a natural reaction. Last year began with a record securities industry aggregate quarterly profit of over $2 billion but finished with a record quarterly loss of the same magnitude. Furthermore, during the bull, industry performance figures constantly showed record results compared to earlier results, and the concurrent rise in brokerages' stock prices and P/Es, lulled many into the "no limits to growth" mentality. And in a sense, this was true -- at least on the surface.

Securities industry revenues had constantly grown; in fact, they grew 25-fold from $2 billion in 1965 to over $50 billion by 1986. Aggregate industry profits also showed a near straight line climb for the past decade, rising over 13-fold from $400 million in 1977 to $5.5 billion by 1986. Industry equity capital grew from $3 billion to $24 billion

over the same time frame while total capital shot from $4 billion to $30 billion. Meanwhile, employment at NYSE member firms surged from about 140,000 in 1980 to 244,000 during 1986, or almost 75%. So, all looked well with this growing industry during the bull.

But there were limits to growth. This "all is fine" appearance on the surface didn't even need a stiff breeze to expose the deteriorating profitability and increased risks beneath.

With all the growth in revenues, profits, equity and total capital, Table 9 shows the declining returns being made on this escalating capital base.

Table 9

SECURITIES INDUSTRY PRE-TAX RETURNS

(In Percent)

Pre-Tax Return on:	80	81	82	83	84	85	86	87	88*
Equity Capital	49.2	35.9	40.5	36.6	13.3	29.4	28.6	4.9	13.4
Total Capital	39.0	29.0	32.3	30.7	10.4	21.4	21.3	3.5	9.4

*First half

The previously mentioned growth masked the marginal returns earned on each new dollar of capital added. From 1980 through 1987, there was a three-fold growth in industry revenues financed by a five-fold growth in equity and total capital. Meanwhile, profits in 1987 were only half the amount booked in 1980, not even inflation or risk adjusted!

The cracks in this mask are not just now being exposed. Since the industry's recovery from 1984's lows, we've had the pleasure of reporting rebounds in profitability for the industry for the 1985 to early 1987 period but always tempered with a note of caution. The aggregates showed hopes for a rebounding industry but the returns being earned never equaled their shinier days.

In Trends, April, 1986, we discussed 1985's welcome rebound from the previous year's poor results. However, we cautioned that expenses, and thus margins, while improved, were not yet under control. For example, in the section, "Expenses - Unstoppable Force Meets Immovable Object," we noted the bad news was that over a period longer than just 1984 to 1985, expense increases still outpaced revenue gains. Further, although profits improved, we noted that 1985's profit margin was still the second lowest since the late 1970s and that ROE, although up from 1984, was still far below the 1980-83 showings!

One year later, in the March 1987 Trends, "A Tale of Two Industries," again reporting on what on the surface looked like another great year, we again cautioned that "If the year's ROE was poor, it was even more so when you consider how much the first quarter helped (keep it) from dropping off the board. For the second half of 1986, the industry was earning only 11% to 12% after taxes on its growing equity base." Further, we warned that by 1986 the industry had "increased its equity and capital base

four-fold since 1980, but it only managed to increase its revenues three-fold and its profits two-and-one-half-fold."

If we look at the year-to-year growth in capital vs. revenues (forgetting for the moment the volatile swings in profits), the industry, as a whole, is hard pressed to justify using more and more capital to chase revenues, let alone "profitable" business lines (Table 10).

Table 10

YEAR-TO-YEAR INDUSTRY GROWTH

(In Percent)

	80	81	82	83	84	85	86	87	88*
Equity Capital	35	25	34	32	9	30	29	13	18
Total Capital	37	20	33	32	18	31	36	18	5
Revenues	43	23	17	27	6	24	30	1	(7)

*First half

This is not to say that securities firms didn't encounter strong pressures to vastly increase their capital during the Eighties, and even earlier. Competitive pressures literally forced firms to seek capital to survive. For Wall Street's old-line major partnerships, not much additional capital could be raised via their partnership structure. Thus, firms merged, sought outside capital-rich partners such as the insurance industry, or went public. The fastest growing profit areas were in capital risk-based areas. Non-capital intensive business lines diminished in importance, i.e., the agency commission business, which had accounted for at least half of all revenues in the mid-Seventies but decreased to about a quarter of revenues by the mid-Eighties.

Trading and investment revenues, which demanded large amounts of capital to finance inventory (and to protect against losses in this volatile area) matched commissions in revenue importance. The SEC's Rule 415 in the early Eighties even changed the nature of underwriting. In order to stay competitive in the underwriting business, firms needed large amounts of capital in order to be able to buy entire issues off the "shelf" simultaneously when issuers saw windows of opportunity to raise additional funds or to refinance.

As firms continued to raise additional capital, as we've seen in Table 10, they also increasingly leveraged this growing base. The securities industry's gross long position in securities (and commodities) grew to $145 billion at the end of 1986. That was a 10-fold increase in 10 years! Over the same time span, the industry's net long position grew eight-fold to $78 billion. The securities industry was taking larger and larger risk positions with its growing equity base. By 1984, the industry had gross long positions eight times greater than its equity base and a net long position quadruple its equity base. Though the industry began to reduce its exposure by mid-1987, October's events accelerated this trend and the amount of inventory firms are now willing to carry has contracted considerably. As of mid-year 1988, the industry's gross and net long positions were down to $109 billion and $38 billion, respectively.

Table 11

EQUITY AT RISK

Industry Long and Net Long Position vs. Equity

	80	81	82	83	84	85	86	87	88*
Gross Long Position	5.4x	5.6x	7.3x	6.0x	7.9x	8.4x	6.8x	4.1x	4.2x
Net Long Position	1.6	3.0	4.0	2.7	4.4	4.1	3.7	1.6	1.4

*As of June 30

But this leveraging was undertaken in the name of profitability. The higher the leverage and the riskier the business line, the greater the profits which can be earned...at least for placing the right bets on a hot market. As the securities industry emerged from the rough times of the early Seventies, its capital base remained at just under $4 billion, with equity capital of just over $3 billion, until this "capital quest" began around 1978. And for awhile, the infusions, combined with the beginnings of a new bull market, yielded higher returns.

As we've noted in the past and here again, less and less revenues are being generated per equity dollar. In fact, Table 12 shows that the industry is now generating only $2 for each $1 of equity, almost half of the $3.50 generated in 1980, and this drops to about $1.50 per $1 of total capital employed (total capital = equity + subordinated liabilities). In other words, the industry, today, would have to more than double its 1980 profit margin (its highest since 1972) in order to just match 1980 ROE!

Table 12

REVENUES VS AVERAGE EQUITY

	80	81	82	83	84	85	86	87	88*
Revenue X Equity	3.5x	3.3x	3.1x	2.8x	2.6x	2.7x	2.6x	2.1x	2.0x

*First half annualized

It is also argued that today's "quest for capital" is tied to a need for funds to do bridge financing and merchant banking in order to earn above average returns or just to facilitate capturing investment banking deals to begin with. And there have been spectacular returns in this arena -- but so far for only a limited number of deals for a limited number of players. There have also been some stunning hits on a few deals gone sour.

If firms need a pool of capital to tap in order to facilitate deals, a firm's own capital is certainly not the only source to tap. According to Sanford C. Bernstein's research, so far this year there are 15 major LBO funds with a target amount of $22.2 billion of capital, $17.5 billion of which has already been committed. That $22.2 billion is equal to the total capital of the 10 largest securities firms in June and more than the total capital of the securities industry at the end of 1985! Although some of this is at the disposal of the "boutiques," -- KKR, Blackstone, Wasserstein & Parella, etc., the

National Full Line firms and Large Investment Banks are the major sponsors of these funds as well.

Furthermore, the deterioration in capital returns has not been limited to those firms which concentrate more on the capital risk areas of the securities business but has been dropping across the board for all types of retail and institutional brokerages (Table 13).

Table 13

PRE-TAX RETURN ON EQUITY

(In Percent)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3	(2.1)	0.7
Lg. Investment Banks	55.7	56.7	54.8	43.8	31.1	38.5	34.2	9.3	21.6
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7	14.1	7.2
New York City Based	N.A	42.1	43.3	50.7	19.9	31.2	35.4	3.9	22.7
NYSE Discounters	N.A	52.2	53.9	46.7	0.8	25.6	49.5	19.7	5.7
Total Industry	**49.2**	**35.9**	**40.5**	**36.6**	**13.3**	**29.4**	**28.6**	**4.9**	**13.4**

*First Half Annualized

Although some of the capital risk endeavors of securities firms are being booked outside the broker-dealer entity (as are non-domestic operations, some asset management, insurance and other non-broker-dealer operations, and thus are not totally reflected in the FOCUS reports which are the source for this Trends' analysis), the decreasing returns being reported by all types of securities firms, even during the bull market years, warrant caution.

The U.S. securities industry's increasingly deregulated and highly competitive environment suggests that the higher returns earned in the 1960s and in the early 1980s may be impossible to duplicate. The "Go-Go Years" of the 1960s, and perhaps the early 1980s, are possibly just that -- highly profitable anomalies that do go.

The industry is now dominated by huge full service financial service firms which were, and are, attracted to businesses that showed high levels of returns. Unless an industry is protected from competition, high profitability will attract new entrants and competition will force down those returns.

Witness the opening of London where competition drove down the margins and caused massive shakeouts. Tokyo's huge returns also are attracting great interest. Japan's regulatory environment protected its securities industry from competition. In 1986, Japan's Big Four -- Nomura, Daiwa, Nikko and Yamaichi -- earned a collective 65% pre-tax ROE vs. the U.S. securities industry's 28.6% or even the U.S. Large Investment Banks' 34.2%. But competition is now increasing there also as Japan's Ministry of Finance begins to open Tokyo's door.

Commercial banks have long sought re-entrance into the investment banking arena to bolster their profitability. However, the securities industry's profitability relative to banking no longer looks that enticing (Table 14).

Table 14

BANKS VS. BROKERS - AFTER-TAX ROE

(In Percent)

	83	84	85	86	87	88*
Commercial Banks	10.7	10.7	11.3	9.9	2.0	11.4
Securities Firms	19.8	7.2	15.9	15.5	2.9	8.6

*First Half

Finally, securities firms which can carefully calculate the profitability potential in arbitrage, where returns must at least exceed returns on Treasuries before committing funds for a single day, must be more careful in committing their capital to operations which produce sub-Treasury returns for entire fiscal quarters or even years.

CONCLUSION

In the past, as documented in this paper, we have been cautious about the profit, revenue, and capital increases in the securities industry during the boom period prior to October 19, 1987. We noted that although things appeared promising on the surface, there were areas of concern, namely, deteriorating profit margins and rates of return mainly because of costs increasing faster than revenues, and massive capital increases in the industry. As expected, it becomes increasingly difficult to find new lines of business where the rates of return are equal to or better than those in which firms were currently operating. This is particularly true if one adjusts for risk as firms increasingly act as principals, either in securities or even in companies.

Now, when it is easy to be pessimistic, we are increasingly turning optimistic. We believe firms have made meaningful cuts in costs and are not simply adding capital for the sake of increased size. In other words, we believe securities firms are getting lean and mean. After all, this is not exactly a normal time for the securities industry. After adjusting for dividend capture transactions, we estimate that average volume on the NYSE is off almost 19% through August, 1988 relative to the average for 1987. The average share of a price traded is down 16.5% compared to last year. Thus, "real" trading is down well over 30% through August of this year.

The American economy, particularly the corporate sector, has gone through major reorganizations and consolidation since the early Eighties. For the most part, the securities industry escaped this upheaval. However, this turbulence was brought home dramatically to the securities industry on October 19, 1987. Events around that time had a sudden, wrenching impact on the securities industry which is still reeling from the repercussions.

We do not expect to see a sudden and dramatic improvement over the first half of 1988. Indeed, we expect things to get worse rather than better in the short run, given the lackluster volume during the third quarter of this year and rising interest rates. Moreover, other areas of the business have not recovered to make up for dwindling volume and lackluster security prices. Frankly, we expect the third quarter figures,

when available, to show even further declines in employment and profits in the securities industry.

We continue to believe it is important to look further than the next quarter or two as far as the securities industry is concerned. This has always been a volatile and cyclical industry. So long as the Federal Reserve continues to use monetary policy and changes in interest rates to slow or stimulate the economy, the securities industry and capital markets will remain the fulcrum from which these policies affect the real economy. For the most part, the "real" economy has weathered the storm that the securities industry has been in since October 19, 1987. Sooner or later, individual and institutional investors will regain their appetite for equities and long-term bonds or their substitutes and acquire them directly or indirectly through vehicles such as mutual funds. The economy is generating too much in the way of real economic gains for this not to be reflected ultimately in security prices and greater activity. When this happens, securities firms will reap the benefits of greater revenues flowing through to the bottom line as expenses have been curbed substantially.

We need not anticipate increases in activity like that experienced in 1987 to be optimistic about the future economic performance of the securities industry. What is needed are periods of more normal levels of activity in the securities markets rather than falloffs in trading values of 25-30% as has happened through most of 1988.

When "normalcy" returns to the capital markets, securities firms will be the beneficiaries. Sooner or later, corporations must seek equity capital. There is a limit to how dependent they can be on debt offerings which has been the case for most of 1988. The American economy has been too innovative to continue to see a lack of IPOs (excluding closed-end bond funds). We also do not think internationalization is a temporary phenomenon and believe that foreign investors will return to the U.S. capital markets in force by acquiring both debt and equity. There are too many positives going for the U.S. capital markets and securities firms for us to be negative, and we refuse to do so.

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Grace Toto
Administrative Assistant

APPENDIX A

EMPLOYEES

(In Thousands)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	81.0	92.9	100.3	112.6	122.5	127.5	143.4	146.4	138.6
Large Investment Bks	15.8	17.8	19.9	23.9	25.1	27.0	33.5	38.1	34.2
Regionals	N.A	31.2	31.5	34.3	36.2	35.6	39.2	42.2	40.1
New York City Based	N.A	10.9	10.9	11.2	11.7	12.4	13.3	16.0	15.7
NYSE Discounters	N.A	0.6	1.2	1.6	2.1	2.7	3.8	5.0	4.6
Total Industry	**139.8**	**160.6**	**171.0**	**192.0**	**207.5**	**214.6**	**244.1**	**260.5**	**245.0**

*First Half

EMPLOYEES
1987:3Q - 1988:2Q

Total Industry

	1987: 3Q	1987: 4Q	1988: 1Q	1988: 2Q	Net Change
Producing	96,580	92,316	90,260	88,941	(7,639)
Non-Producing	165,583	168,169	158,104	156,022	(9,561)
Total	262,163	260,485	248,364	244,963	(17,200)

APPENDIX B

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In $ Millions)

Revenues	1Q88	2Q88	% Change
Commissions	2,435.0	2,230.8	(8.4)
Trading Profits	3,110.9	2,662.3	(14.4)
Investment Gains	828.8	240.6	(71.0)
Underwriting	1,187.7	1,364.3	14.9
Margin Interest	657.5	697.5	6.1
Mutual Fund Sales	430.0	359.1	(16.5)
Fees, Account Supervision	353.4	486.7	37.7
Research	9.8	5.0	49.0
Commodities	366.7	364.4	(0.6)
Other Securities Related	2,933.1	3,211.4	9.5
Other Unrelated	751.8	828.4	10.2
Total Revenues	13,064.7	12,450.6	(4.7)
Expenses			
RR Compensation	2,053.9	1,916.7	(6.7)
Clerical Compensation	2,486.1	2,326.5	(6.4)
Partner Officer Comp.	355.4	301.8	(15.1)
Other Employee Comp.	139.1	125.6	(9.7)
Floor (Commission Clearing)	444.3	437.3	(1.6)
Communications	611.9	652.4	6.6
Occupancy & Equipment	751.6	776.9	3.4
Promotional Costs	234.6	261.2	11.3
Interest Expense	3,367.5	3,588.6	6.6
Errors Bad Debts	110.3	127.1	15.2
EDP	182.7	181.6	(0.6)
Non-Recurring Charges	11.4	14.1	23.7
Regulatory Fees	87.3	95.1	8.9
Other	1,082.0	1,092.9	1.0
Total Expenses	11,918.1	11,898.1	(0.2)
Pre-Tax Net Income	1,146.6	552.5	(51.8)

APPENDIX C

In issues of Trends, SIA analyzes the financials of the "total securities industry" as well as firm category components. The "total industry" is actually a proxy for the total industry -- it is the New York Stock Exchange (NYSE) member firms which do a public business. SIA and the NYSE maintain a joint database (available to members of either organization) which updates the financials of these groups of firms on a timely, quarterly basis. The data are derived from the regulatory FOCUS (Financial and Operational Combined Uniform Single) Report filed with the NYSE.

As the table below shows, this group of firms, although small in number when compared to all broker-dealers reporting to the Securities & Exchange Commission (SEC), still account for the vast bulk of securities business done in the U.S. Even with the number of all firms reporting to the SEC almost doubling since 1979, and the NYSE group remaining around 400 firms (395 at year-end 1987), the NYSE group has maintained its dominance of the financials. Also, as the table below indicates, all firm data (available only annually) is released quite late -- this issue of Trends covers the NYSE group's performance through the second quarter of 1988, while the SEC released 1987 results in late August -- another reason for using this NYSE group as a proxy for the industry.

NYSE GROUP'S SHARE OF TOTAL INDUSTRY*

(Percent)

Item	79	80	81	82	83	84	85	86	87
Revenues	80	80	81	81	80	79	77	78	77
Assets	84	85	78	86	86	88	87	87	85
Capital	66	65	66	70	71	71	71	71	75
Equity	63	63	65	69	70	68	68	69	71
# of Firms									
NYSE Group	374	389	390	387	412	393	381	417	395
All Firms	4,824	5,283	5,714	6,165	7,374	8,272	8,957	9,436	9,196

*Total industry based on data from the SEC Monthly Statistical Review, August 1988.
NYSE Group: New York Stock Exchange member firms doing a public business.

VOLUME

	JUN 1988	YTD 1988	JUN 1987	YTD 1987	% CHAN YTD 1988-1987
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	195.8	174.7	163.4	179.7	-2.8%
AMEX (MILS.)*	11.8	10.6	12.8	14.1	-24.8%
NASDAQ (MILS.)*	141.6	128.3	149.3	149.4	-14.1%
REGIONAL EXCHANGE (MILS.)*	26.9	24.1	25.6	27.1	-11.1%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$142,031	$726,370	$147,548	$931,947	-22.1%
AMEX (MILS.)	3,216	16,772	4,243	27,285	-38.5%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	7,326	44,156	9,271	65,627	-32.7%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	16,528	89,734	15,562	107,334	16.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	60.6%	52.4%	52.8%	51.1%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	10,404	54,932	13,190	97,305	-43.5%
AMEX OPTIONS	3,830	19,175	4,181	26,333	-27.2%
COMMODITY	26,552	122,604	20,046	112,339	9.1%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

	JUN 1988	JUN 1987	% CHAN JUN 1988-1987
DOW JONES INDUSTRIALS	2141.71	2418.53	-11.45%
STANDARD & POOR'S 500	272.50	304.00	-10.03%
NYSE COMPOSITE	154.47	171.07	-9.70%
AMEX MARKET VALUE INDEX	309.25	338.13	-8.54%
VALUE LINE COMPOSITE	240.04	268.59	-10.63%
NASDAQ COMPOSITE	394.66	424.67	-7.07%

YIELDS

(MONTHLY AVERAGES)

	JUN 1988	JUN 1987	BASIS POINT CHG 1988-1987
BOND BUYER INDEX (20 BOND)	7.78%	7.79%	(1)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.86	9.32	54
Baa CORPORATE	11.00	10.52	48
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.89	1

UNDERWRITING

	First Half 1988	First Half 1987	% Change 1988-1987
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$147,760.7	$150,220.7	-9.1%
Common Stock	$16,033.7	$25,591.6	-37.3%
# of Common Stock Issues	196	512	-61.7%
Preferred Stock	$3,414.3	$6,987.2	-51.1%
# of Preferred Stock Issues	61	96	-36.5%
Corporate Debt	$124,312.8	$125,646.0	-1.1%
# of Corporate Debt Issues	1,547	1,321	16.8%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$38,195.9	$44,652.2	-14.5%
# of Issues	1,525	1,776	-14.1%
Competitive	$13,976.2	$13,281.3	5.2%
# of Issues	1,604	1,821	-11.9%

Source: IDD Information Services

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
THE BUDGET DEFICIT The Causes, The Costs, The Outlook	Economist Leonard J. Santow, Ph.D., examines the causes and outlook of the federal deficit including: "party-in-power" factors; Gramm-Rudmann-Hollings; usefulness of the debt ceiling; impact of current Treasury financings on future debt management; is a balanced budget amendment feasible; relationship between deficits and interest rates; budgetary policies and timing of budget submissions, and much more useful facts and insight into the deficit problem today.	1988 New York Institute of Finance, Publishing & Professional Information Services New York, New York
"Global Equity Analysis Report"	This new SIA report is designed as a tool for determining the direction and volume of global equity flows. It delineates the growth in international equity trading; volume activities in foreign equities by Canadian, West German, United Kingdom, Japanese and United States investors, and much more with analysis by SIA's Research Department.	SIA Research Department
"Distributional Aspects of a Federal Value-Added Tax"	Using a newly-developed measure of income, this article evaluates the regressivity of this tax (a barrier to its political acceptability), analyzes options for reducing this regressivity, analyzes the usefulness of this tax in reducing the deficit without adversely affecting savings,	National Tax Journal June, 1988
"Basket Investing: The New Force in the Stock Market"	Two-part article on how markets have shifted from stocks trading on their own merits to basket trading of securities. Topics discussed include: fears by individuals, institutions and regulators; index funds; effect on capital-raising function, and the response by the exchanges themselves.	Institutional Investor September, 1988

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
"Commercial Banking' Performance - Second Quarter 1988"	FDIC quarterly report shows commercial banks earning record profits in 1988's first half as well as the second quarter. Despite banking industry earnings' drags from problem banks, particularly in Texas, report shows banking industry's rebound from periods of LDC writedowns.	FDIC Quarterly Banking Profile Second Quarter, 1988
Japan M&A Reporter	This bi-monthly newsletter covering U.S./Japan M&A activity discusses a pickup in U.S. companies' Japan subsidiaries/joint ventures plans for IPOs in Tokyo over the 1988-90 period. Includes listings of completed or pending acquisitions, IPOs, investments joint ventures and real estate deals.	Ulmer Brothers, Inc. New York, New York
The Spicer & Oppenheim Guide to Securities Markets Around the World	Second edition guide to 26 of the most important securities markets in the world including updated information on size of markets, tax developments, settlement and clearing arrangements, new issues, futures and options markets, etc.	John Wiley & Sons New York, New York
"Resolving the Tax Issues Arising in Bank Rescues"	Article describing the FDIC's treatment of the NCNB Corp.'s takeover of First RepublicBank Corp. and the conclusion that the IRS's rulings were a movement forward in resolving tax issues in bank takeovers but that legislation will be needed to achieve certainty in tax issues regarding these transactions	Tax Notes 9/26/88